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Creation of a Capitalist Financial System

Hyman P. Minsky Ph.D.

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THE CREATION OF A CAPITALIST FINANCIAL SYSTEM

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"THE END OF THE SOVIET EMPIRE AND ITS INFLUENCE ON THE
GLOBAL ECONOMIC AND MONETARY SYSTEM".

PRELIMINARY

- 600 Billion
- 1) Medical Care with
cost structure of fees
- 2) 13% + shift to
data sharing
- 3 Parts
- ① Principles of
Centralization
or Segmentation
+ Transparency
- ② List of Functions
"Banking"
- ③ Existing Functions
- ④ Conclusion
5 The

ABSTRACT

The end of the Soviet Empire has led to a remarkable decline in the outputs of both the former European satellites of the Soviet Union and in the now multiple regimes of what was the Soviet Union. The closely articulated input output relations among enterprises, the obsolete ideas of the efficiency of large scale production units (the freezing of 1927 ideas about efficiency) which guided Soviet plant design, along with the absence of a financial system for independent enterprises is largely responsible for the observed decline in output.

This paper, The Creation of a Capitalist Financial System is a mainly taxonomic paper which describes the functions of banking. The complexity and the number of dimensions of a capitalist financial system is detailed. Taking the United States reform of its financial system as a possible model it is suggested that the United States' model of a compartmentalized financial system combined with the doctrine of transparency for financial markets and both public and private corporations is an appropriate model for the development of a financial system in the former Soviet Empire.

One implication of the complexity of a capitalist financial system and the time it will take to develop the institutions is that the "shock therapy" approach to the building of capitalism is counterproductive. An alternative three pronged approach of "creating a financial structure, 2) freeing small business and creating market oriented agriculture, and 3) using public holding companies (RFC's) for the reorganization and privatization of large state enterprises) would be a more efficient way to go.

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I. INTRODUCTION

It is likely to go down in history as an oddity that just as European Soviet style communist regimes collapsed the economies of the "victors" in the cold war entered upon a bad patch.⁷¹ The seriousness of the bad patch of the capitalist economies in the 1990's is not, to use an Americanism, in the same "ball park" with either the bad patch that the United States and other Western capitalisms had in the 1930's or the catastrophic failures of the Soviet style regimes.² However, the present performance of high income capitalist economies stands in sharp contrast to their success during the long era of post war reconstruction, the cold war and economic growth that stretched from the end of World War II until the 1980's. This successful capitalism of 1948-1980 differed markedly from earlier periods of expansion under capitalism in that the benefits of the success were broadly distributed through the population.

1. This development might be used to advance the Marxist argument that "Capitalism needs a war economy to sustain a close approximation to full employment" which is echoed by the conservative argument that deficits did not help contain and end the Great Depression, World War II ended the Great Depression. Both the Marxist and the conservative position reveal a lack of understanding of the full significance of the insights to the operation of a capitalist economy of the analytical apparatus derived from Keynes' General Theory.

2. One should not underestimate the possible dire consequences of current political developments in Europe. As long as citizenship is defined by "blood" the threat of Fascism and ethnic cleansing is ever present. Perhaps capitalisms must do well or sink into the chaos of rival fascisms.

The evolution of the financial system over the entire post war era is a factor making for this decline in the quality of performance by the capitalist economies. This evolution was driven by four elements:

1. The impact of the extended period of success upon portfolio preferences of households, businesses and financial institutions transformed the financial structure from being robust to being fragile.
2. changes in the technology of computing and communicating,
3. changes in the distribution of wealth within and between national economies and the adjustment of financial institutions and markets to the forms in which households hold wealth, and
4. the "contamination" of the regulatory process by the simplistic view that the "market knows best".³

One result of the concurrent collapse of Communism and malaise of Capitalism is that even as capitalist financial systems need to be created in the former Soviet world there is a need to reform the weakened financial systems of the Capitalist world. The rest of this decade and the first decades of the next millennium are likely to be dedicated to three projects: creating capitalism, reforming capitalism and

3. According to the Financial Instability hypothesis variant of Keynesian Theory, which I advanced in both John Maynard Keynes (Columbia University Press, 1975) and Stabilizing an Unstable Economy (Yale University Press, 1982), the first point, the endogenous transformation of the financial structure over periods of successful operation, is sufficient to transform a financial structure from being robust to being fragile.

making various capitalisms work so that a prosperity whose benefits are broadly distributed among the countries and within the countries can be achieved.

The development of a legal structure which facilitates borrowing and lending by making precise what follows when a borrower does not fulfill the terms of a contract is a critical element in the creation of a capitalist financial structure. These laws usually provide for the shifting of title from debtors to creditors when the terms on a contract are not fulfilled. In what follows the details of the bankruptcy laws that are needed to assure a well functioning capitalism are ignored: we assume the problem has been addressed.

II. THE 1930'S REFORM OF THE AMERICAN BANKING AND FINANCIAL SYSTEM⁴

The great contraction of the American Economy is commonly dated as beginning with the Stock Market crash of October 1929 and continuing until the inauguration of Franklin D. Roosevelt as President on March 4, 1933. On inauguration day, a Saturday, the new President was

4. The first 6 years of the Roosevelt administration, 1933-1938, was a remarkable period of constructive legislation which resulted in the financial structure of a modern corporate Capitalism being put in place. At the end of World War II these the principles underlying the reforms of 1933-38 were "exported to" or imposed upon Germany and Japan. The decentralization and openness principles of the American structure did not take hold: Germany and Japan reverted to their old financial patterns, albeit the old wine is in new bottles.

informed that the New York banks would not be able to open on Monday: as it was the banks in some 30 states had already been closed by their Governors. The imminent closing of the New York banks led the new President to close all banks. This bank holiday was thrust upon Roosevelt, but with the closing of the banks the capital of the United States' financial structure moved from Washington to New York.

The Federal Reserve System was not the main actor in the reopening of the Banks during the weeks that followed the inauguration. The main actor was the Reconstruction Finance Corporations (RFC), a government institution which could take "equity" positions in distressed financial institutions and ordinary business firms. The situation of the banks in the late winter of 1933 was viewed as an insolvency, not as a liquidity, crisis.

After March 4 RFC agents quickly examined the closed banks. The banks were divided into three classes: those that could reopen on their own, those that could reopen after an equity infusion by the RFC and those that were so weak that even a substantial equity infusion would not make them solvent. About 2/3 of the banks were allowed to reopen and of those that reopened some 50% required RFC refinancing.⁵

5. In essence half of the United States banks were nationalized during the bank holiday. In the long expansion and the Great War that followed 1933 the "nationalized banks" bought the preferred stock that had been issued during the crisis from the RFC, using

The wholesale bank and financial system failures of the 1929-1933 era forced the enactment of emergency legislation during the first 100 days of the Roosevelt administration, but it is the banking and financial legislation of 1935, 36 and 37 that contains the enduring response to the failure of the financial structure and the collapse of the economy in the great contraction. This legislation created the big government interventionist capitalism that proved to be so successful after World War II.

Two principles guided the reforms of the financial system: Compartmentalization (segmentation) and transparency. Compartmentalization means that banking and financial institutions specialize in the assets they own and the liabilities they issue to finance their activities. It can be called a "horses for courses" approach to financial institutions: the course being the financing of some economic sector or the providing of instruments for transactions or the holding of wealth. Thus ^{the} mutual "Savings and Loan Associations" were chartered to specialize in the financing of 1 to 4 family houses and were to have liabilities (savings liabilities) which could be withdrawn on short notice and whose value could fall to a discount if the value of their ^{institutions'} assets fell below par. Similar specialized institutions were set up for financing rural ⁴⁻⁶⁻²⁻ electrification ^{through the Federal Reserve Bank's} and exports.

Separation of
Commercial &
Investment
Banking

either internally generated funds or the proceeds from a market sale of equities.

Transparency has two distinct attributes. One deals with markets for securities and requires that all transactions of widely held securities be done in "public" and the second deals with the full disclosure of the finances, profitability and the governance of publicly held corporations. Public dealing and public information are to protect the owners of equities and the creditors of companies: manipulation of the public stock markets by market operators was to be barred.

Compartmentalization was introduced so that the overseers and guarantors could readily understand the businesses with which they dealt. Complexity, in terms of the multitude of markets and instruments in which a financial organization operates, is a barrier to effective oversight. Segmentation of organizations so that specialization in assets and liabilities is achieved simplifies control by both management and government overseers.

The two principles, compartmentalization and transparency, were coupled in the effort to create a financial system which was sharply focused on the capital development of the country. The aim was to create a financial system that is oriented to the provision of secure outlets for savings and available sources of finance for identified segments of the economy.

A segmented financial system of necessity uses financial markets to coordinate the diverse financial

institutions. For such coordination to be at all efficient financial markets need to be transparent so that institutions and individuals have trustworthy information upon which to base decisions.

The United States financial reform legislation of the 1930's created a legal and institutional framework for a corporate capitalism in which ownership of wealth is broadly distributed through the population and which bars the development of powerful clubs of corporations which are coordinated by a dominating financial institution.⁶

III. THE FUNCTIONS OF "BANKING"

A. A LIST OF FUNCTIONS

The following functions of a banking and financial system can be identified:

1. Operate the payment mechanism, especially the mechanism for making payments at a distance, both nationally and internationally.

2. Provide commercial banking services such as loans to business including information about the credit worthiness of agents at a distance.

3. Provide safe and secure transaction balances and outlets for household savings.

6. J.P. Morgan & Co was the prototype dominating financial institution against which the legislation of the 1930's was aimed was .

Handwritten note:
[Keynes] Capital Development
is speculative
considered as a bubble
is not likely to hold
he would die

4. Finance housing and provide consumer credit.
5. Provide investment banking services.
6. Provide trust services, as well as portfolio guidance for households.
7. Create secondary markets for financial instruments. including the creation of markets for corporate control.
8. Provide protection against well defined contingencies including price risks: futures, puts, calls etc.

In addition to the eight functions of private financial institutions all advanced capitalist economies have

9. A central bank which supervises, inspects and protects the economy against the consequences of a malfunctioning of the financial system.

The above list of the functions that a well regulated financial system provides indicates that more is involved in creating a financial system for a capitalist economy than chartering banks and opening a stock market. Even economies, such as Germany, which have universal banks as the dominant institutions in their financial structure have a multitude of special institutions. It should also be noted that institutions which carry out banking functions need not be chartered as banks.

The complexity of the financial function indicates that an economy emerging from being Communist should make provisions for a highly decentralized financial structure which contains a multitude of different types of organizations, not all of which are chartered as banks. The institutions and usages of each capitalist country evolved over centuries in responses to profit opportunities and crises. Each emerging economy will develop its institutional forms as it evolves in response to international and internal opportunities. The expectation has to be that this learning process will include false starts and the adoption of forms which will prove to be inappropriate.

B. EXPOSITION.

It is necessary to explain each of the listed functions of the banking system. Every aspect of banking and finance has to be placed in the context of the social and technological conditions of an economy. Furthermore not all functions which can be identified for advanced capitalist economies need be performed in every economy. What functions are necessary will depend upon the stage of development and the technological infrastructure of the economy.

I will not explain each function in like detail. I spend more space on the payments mechanism because it is undergoing rapid changes in the advanced capitalist economies and because a well functioning payments

mechanism is necessary for a capitalist economy to function well.

1. OPERATING THE PAYMENT MECHANISM.

A smoothly functioning and reliable payment mechanism is necessary if a capitalist economy is to operate well. In an advanced Capitalist economy the payments function is carried out by a number of mechanisms: currency and coin, checks and gyro accounts, electronic transfers between accounts at financial institutions and credit and debit cards. This means that the money of the economy comes in a variety of forms. All of the agents in the economy do not use all of the money forms. Thus, in addition to the facilities needed to operate each type of money, in an economy with multiple forms of "money" a mechanism is needed by which agents in the economy can transfer their money from one form to another.⁷

An economy can be visualized as producing a hodge podge of outputs and financial instruments. In a Capitalist economy the payment system is a mechanism by which rights, to draw from the jumble of goods and services produced in the economy and to acquire financial instruments and capital assets, without engaging

7. In the United States the poor and the inhabitants of the black neighborhoods to a large extent have been excluded from the checking and the credit card systems. In these neighborhoods systems of "currency exchanges" have grown up which exchange checks into currency and currency into money orders for a fee. This institutional arrangement, which has developed in response to market opportunities, is the emergence in a new guise, of non-par clearing which was a common practice in the earlier days of deposit subject to check banking in the United States.

For those in advanced economies who are affluent enough to use normal banking channels the process of going from a deposit to currency is mainly automated: Automatic Teller Machines have largely replaced the human teller.

in any additional transactions are distributed through the population. It is also the mechanism by which the receipts from output produced are distributed to those who have contributed to the production of output. The payment mechanism is so to speak a score keeper.

A secure and efficient payment mechanism is necessary for the effective functioning of a market economy. In particular an efficient payment mechanism allows for the close articulation of receipts and expenditures - it allows for the close planning of activities by units.

Therefor reliable, secure and rapid communications are a prerequisite for a monetary economy. The particular institutional forms that the payments mechanism takes largely reflect differences in the technological and legal infrastructures of the different economies.

A payment system uses resources: every payment system has costs which have to be covered by fees or some form of subsidy, either from the state or from financial institutions which receive income from operating the payments mechanism.⁸

a. Currency and Coin

Paper currencies and token coins make up the cheapest payment mechanism, as measured by the resources used to operate the mechanism and to keep a record of individual rights to draw from the common pool. With paper currency and token coins the only communal direct costs are those of printing and minting.

8. It should be pointed out that the income from operating a travelers check comes mainly from the interest earned by investing the amount understanding in financial markets.

Seignorage, the differences between the cost of producing the currency and coins and their nominal value when issued by the government or mint, covers the communal costs. Costs of safekeeping and record keeping for a currency and coin money supply are carried by the units involved in transactions.

A currency system puts the burden of safekeeping of a unit's money upon the unit. Possession of currency and coin carries the right to spend: this money form provides no protection against theft or agents conveying money to their own use. There are no records in financial institutions which monitor the unit's right to spend and which can be used to trace spending. A currency system makes it difficult for complex organizations to monitor the spending by their agents. Within a modern large legal enterprise the use of currency is restricted to petty cash. Currency and coin are convenient for face to face transactions but they are inconvenient for payments at a distance. In addition, for transactions that involve large sums of money, currency can be quite bulky.

b. Rights to Draw and to Transfer.

Whereas currency and token coins are part of every payment system, in modern developed economies they are a secondary part of the total payments mechanism. In modern economies payments are largely made by transferring credits (deposits) in accounts at banks from one party to another. This will usually mean a transfer from one bank to another. It does not matter whether the credits (deposits) are in the form of entries in the books of a bank or entries in a computer's memory.

A payments system in which checks, drafts or negotiable orders to transfer are the principle way of transferring money from one account to another has obvious advantages in safe keeping and record keeping over a paper currency and token coin system. An reliable, quick and relatively cheap postal or courier system is a prerequisite for the effective operation of a payments system that is based upon paper checks.

Inasmuch as a check system involves an order (check) by a client of a bank to its own bank to transfer funds to the order of a named unit or to the bearer, and such a "check" is usually transferred to a fourth party, the named unit's bank, for collection a system is required which links all the institutions upon which checks are drawn and to which checks are deposited. At different times these linking systems have been clearing house organizations which were private clubs, leading banks in financial centers which in turn are linked by a clearing house, and the central bank. Clearing, especially at a distance, is facilitated when the various institutions upon which checks will be drawn keep deposits, credit balances, in some common bank or other institution. In the United States before the Federal Reserve Act and for international transactions today, banks are linked through "correspondent" relations, which often take the form of the holding of reciprocal balances.

It is clear that a payment system based upon checks requires an in place institutional structure. This institutional structure needs to be dense over the economy if the check system is to effective throughout the economy.

Obviously a check system involves the use of resources. For many years the standard rule of thumb in the United States was that a checking account system costs a bank some 3.5% of the deposits subject to check each year. In the standard "free checking" offers the interest rate earned on bank assets needs to exceed the rate paid on depositor balances by 3.5%; furthermore there usually is a minimum balance which entitles the customer to free checking, an unlimited number of deposits and access to automatic teller machines. In a low interest rate environment banks levy specific charges against account activity.

In economies where the lending business of banks is poorly developed, the charging of fees for depositing checks, exchanging currency for checks and for issuing checks is a usual practice. Such non par clearing and other fee for services charges are likely to be necessary features of an emerging banking system in countries where the lending to business and the servicing of household's need for financial assets is poorly developed: money changing is likely to be a major profit center of an emerging banking system.⁹

c. Overdraft systems.

Over recent years in the rich countries credit cards have become an increasingly prominent part of the payment mechanism. These cards are really overdraft cards which do not in general charge for the overdraft within a billing and payment cycle but start accruing interest at the end of the billing and grace period

9. If some hard currency - the dollar or the mark - becomes a de facto money in an emerging economy then another dimension is added to the payments mechanism.

for payments cycle. Inasmuch as the credit card companies reimburse the venders for the charges made upon the presentation of the voucher - which is instantaneous for fully electronic systems - a major cost of the charge/credit card system is the interest on the outstanding charges that have not yet been billed or paid. The credit card companies have been on the leading edge in the computerization of transactions and the modernization of communications in order to cut down this float.

The venders discount, i.e. the vender receives a discounted value of the charges he submits for payment, was the innovation that launched the charge/credit cards. The venders discount is less, as a % of sales, than the cost of a merchant's private credit card. The credit card leveled the playing field between the smaller local or specialized merchant and the dominant retailers by allowing these firms to offer charge and credit terms on a par with giant firms.

The costs of the pure payment function part of the credit card is covered by annual fees and the vender's discount. Each credit card has a limit as to the amount of credit which they extend on a card. Card issuers compete in the amount of credit which can be advanced to a customer and the interest that will be charged if the card is used for other than the payments function. There is no effective control on the number of cards a person can have. In the recession of 1990-91 and the continuing slack many credit card companies lost money on overextended credit: American Express Company lost an enormous sum on its Optimum card.

In actual operation the card is used for payment only after a verification of the credit by the issuer. This means that a

well nigh dedicated telephone line from the vender to the card issuer's computer is necessary. The credit card payments system requires a sophisticated electronic infrastructure which links venders, the vender's credit card company, the card issuer's computer, and various banks. The computer system of a large world wide payments card issuer such as American Express needs to be able to store up to the minute information about the status of many millions of credits: furthermore the computers need to be able to block credits on stolen or lost cards.

Debit cards are payment cards which are linked to the positive balance current accounts at banks of holders. They deduct the amount of the payment from the card holders account instantaneously. This system also requires an electronic network. The electronic systems, whether in the form of credit or debit cards, decrease and even eliminate some of the floats in the system.

A payment made by a credit card to a large scale user who therefor is linked to the card issuer's computer will credit the account of the firm that made the retail sale immediately even as it recognizes the credit on the payers account. Although direct satellite access can overcome the deficiencies of the local electronic network for communications between a national credit card headquarters and its computer, the system is dependent upon the efficiency of the local telephone network if it is to achieve broad coverage.

d. Evaluation

Currency and coin will be the main payments mechanism for households for the near term future for the countries of the

former Soviet Empire. An initial development aim should be to create the infrastructure needed so that enterprises of all sizes throughout an economy will be able to use either checks or some form of electronic transfer to make interfirm, and firm government / government firm payments. Retail businesses will receive currency and coin which they will deposit in banks. Their payments to suppliers and the government will be by check. Payrolls will be by currency until an efficient currency exchange system develops.

Regional developments are likely to differ. A city and its periphery might establish a local clearing system as well as a bank sponsored courier system so that checks will make move rapidly and safely to and between banks. An alert local administration can facilitate the evolution of the local payment mechanism.

A modern efficient payments system requires many outlets in which currency can be exchanged for deposits, in which currency today can be placed in safe keeping for currency next month or next week, and in which checks can be exchanged for currency. A multiple outlet financial system is necessary for a efficient payments system.

2. PROVIDING COMMERCIAL BANKING SERVICES

The effective operation of a market economy requires that a wide variety of firms use credit of various forms. Organizations which can satisfy the credit needs of a wide variety of customers need to be developed throughout the economy. In the initial low income stages of a capitalist economy much of the credit may be extended by merchants who supply goods to street venders, peddlers

and small retail outlets. Consignment of goods is practiced in retail merchandising where credit to retail outlets is in short supply: consignment is a form of credit extended by manufacturers and wholesalers to venders of various types. Merchant banking is a term that recognizes the blurred line between extending credit in the form of an inventory of goods and extending credit in the form of a money loan. *Accounts receivable financing - m*

An information system about the creditworthiness of individuals and firms needs to be built in the economies emerging from Soviet rule. The bankers of a community are specialists in evaluating the creditworthiness of members of their community. By extending guarantees with recourse they can facilitate the granting of credit in the community within which they are known. These same bankers through their contacts with bankers in other communities are the source of information about credit worthiness of unknown customers and the worth of a particular bankers guarantee of a credit.

The rating of credits by public credit rating services, which is a usual practice in advanced capitalist economies requires more detailed information than we can expect to be available in the foreseeable future in the former Soviet Empire. An information system that relies upon the credit ratings based upon resident banker's private information and willingness to endorse is a more feasible foundation for the development of credit systems in emerging capitalist economies.

Bankers need to fund their extensions of credits. Endorsing the credit worthiness of clients may well involve endorsements with recourse. They are able to do this by being rich and by

earning large incomes from safekeeping assets, providing mechanisms for payments and collections and offering guarantees for third person's credits. Only as their deposits grow will they be able to make deposits subject to check available.

The operation of the checking portion of the payments mechanism, especially that part which involves payments at a distance, is a natural outgrowth of the banker's role as the local contact person with bankers in other communities and as the witness to both the trustworthiness of agents at a distance and the trustworthiness of locals to those at a distance with whom they deal.

One aspect of Soviet society was the discouragement of in depth communications between members of different communities. The initial condition for the development of the financial system is a lack of the type of knowledge and prior dealings which makes the community of bankers function within and between communities. It will take time for a decentralized banking community to develop.

3. PROVIDING SAFE AND SECURE TRANSACTION BALANCES AND OUTLETS FOR HOUSEHOLD SAVINGS.

One argument against limiting deposit insurance to small deposits is that the transaction deposits of institutions which require more cash on hand subject to check that a limited deposit insurance will cover can be at hazard. Such institutions can be rendered insolvent or at least illiquid by a bank failure. Transaction balances need to be protected against all but minor variations in value.

Households need safe and secure outlets for saving, especially for carrying balances between receipt intervals and payment needs, for example between a monthly income and daily spending. A household oriented institution which offers interest bearing savings accounts which permit a limited number of withdrawals per month is a necessary part of the banking and financial structure of a capitalist economy. In historic capitalist economies the savings bank system was often a benevolent institution which received support from community leaders because it was a device for the uplift of workers. The mutual savings and mutual savings and loan institutions of capitalism can be a pattern for household oriented savings institutions.

4. FINANCING HOUSING AND PROVIDING CONSUMER CREDIT

In a modern capitalist economy special provisions are made for the financing of individual home or condominium ownership. There is little doubt that housing for ordinary workers almost always needs outside financial support if it is not to degenerate into slum housing. The linking of safe repositories for household funds, institutions that educate workers to the virtues of thrift and the financing of housing is common in advanced capitalist states.

In modern capitalist economies debt financing of consumer durables, including private automobiles, is common. Sales finance companies, which often were

founded to finance a companies sales are necessary. Credit unions and the activities of savings banks often extend consumer credit.

5. PROVIDING INVESTMENT BANKING SERVICES

Firms finance positions in capital assets by some combination of funds derived from the owners and managers with funds of others. If accrual accounting is used then the liabilities of firms include as yet unpaid, though earned, wages as well as yet unpaid, though received, goods and purchased services. As firms become too large for an owner's or an organizer's private capital base and as expansion opportunities exceed what internal funds can finance, liability structures become complex combinations of equity shares and debts in the form of negotiated loans from banks and other financial intermediaries and equity and debt market instruments.

Firms need the advice and the services of agents who have knowledge about various financial markets and the connections which open doors to financing. A time arises in the expansion of a successful firm that has been relying upon a local bank for external financing, when the bank suggests that a diversification of the liability structure to include financial instruments such as longer term credits that are privately placed, public offerings of equity shares, or lease arrangements for plant and equipment. Alternatively, in the United States, where there is a large and

diversified set of investment bankers, successful, and to tell the truth often not very successful, firms are called upon by investment bankers who offer their services to provide financing or at least advice about financing.

The "investment banking" part of banking has a variety of dimensions. One is as the advisor of firms as to their best liability structure, another is to act as an intermediary in the placing of the liability of firms and a third is to make a market in the liabilities of the firm it advises and for issues it underwrites. Investment bankers are also the contact between a local financial community and other financial communities.

Investment bankers also act for clients, whom they advise on the composition of their portfolio: which stock issues have favorable prospects and which do not. This leads to the moral dilemma of investment bankers - is an investment banker mainly looking out for the interests of the investor, client firms, or his own personal well being.

6. PROVIDING TRUST SERVICES

Trust services extend from the holding of assets in trust for heirs, holding and managing the principle of pension funds and allocating benefits of pension funds to claimants, to receiving the total of a dividend or interest on a issue of stocks or bonds and distributing the funds to the individual holder. A

"new" market instrument such as the securitization of mortgages requires the services of trust departments. Trust departments of banks are very profitable.

A fully functioning financial system on the American model requires a well defined set of competing organizations which provide trust services.

7. CREATING MARKETS FOR CORPORATE CONTROL

One function of the stock market is to provide a market for corporate control. In the United states this has been evident in both the take over and merger boom in the 1980's and the way in which Chief Executive Officers of various companies have been replaced when they lost favor with fund managers.

Some suggestions for the privatization of large scale enterprises have provided for a wide distribution of ownership so that no one individual or group of individuals, perhaps with the exception of management, has any significant number of shares. The experience in the United States is that such wide spread stock ownership leads to virtually unconstrained management control of the operation.

In the early stages of the transformation of Soviet style Socialism into capitalism the mechanism of a number of government holding companies subject to intense transparency requirements be created which are instructed to prepare programs for the privatization or the closing down of their subsidiaries. Meanwhile the

individual companies within the holding companies portfolio are instructed to maximize profits within a state mandated and financed program of scheduled staff reduction.

8. PROVIDING PROTECTION AGAINST WELL DEFINED PRICE RISKS

A major development in the recent past has been the explosion of bank treasuries and investment banks that deal on their own account in derivatives: instruments which are designed to protect economic agents that either trade across national financial systems or have internationally diversified portfolios against specified contingencies. The need for the unit that sells such derivatives to protect itself against adverse developments, i.e. to balance its books, leads to a variety of position taking in a variety of markets. It can be argued that if the pattern of trades, that are needed to close a book that consists of some of the sophisticated instruments, is done in sufficient volume then the changes in asset prices and interest rates will open the books even further. That is what is done to close an open position opens up further positions. Actions undertaken to stabilize a market destabilizes the markets.

In terms of the economies emerging from Soviet Communism I expect this is of theoretical rather than of immediate practical issue.

9. CENTRAL BANKING

A set of institutions that combine to set standards for the operation of banks and other financial institutions and which stand ready to intervene to protect the value of the liabilities of some institutions is a feature of the financial structure of every advanced economy. In some cases the supervision and support structure of the financial institutions is a single special bank which may be government owned and whose principle officers are appointed with the approval of the government, in other cases there will be a number of different government owned or sponsored organizations and in still a third case these functions will be undertaken by a private organization. The aim of these different structures is to assure that the liabilities of particular financial institutions will be honored at par.

In the United States the reform era of the 1930's led to a compartmented financial structure: member banks, nonmember banks, state chartered banks, banks chartered by the National government, savings and loan organizations and credit unions had different government organizations that acted as their regulator, examiner and stand by and emergency refinancing agency (lender of last resort). *Insured banks, security loans, basic laws for funds etc* Deposits at banks, savings and loan associations and credit unions were insured by separate organizations. Brokerage houses and insurance companies in many states have schemes in which solvent institutions would be assessed to make up deficiencies in the ability of weak or insolvent organizations to fulfill obligations on investors balances or insurance policies.

The argument for having authorities with flexible powers and discretion who act to regulate and oversee banks and other financial institutions is that of experience: the history of banking and financial systems is rife with examples of both individual cases of fraud and systemic breakdowns. The issue is not whether there should be a lender of last resort and supervising authority over financial institutions but whether there should be a single organization which covers all financial institutions or a number of organizations each of which specializes in the chartering and oversight of a particular type of organization.

A starting point for thinking about the development of the financial institutions for a capitalist economy in the countries that have emerged from the former Soviet Empire is the fact that talent to operate and manage financial institutions and central banking facilities is scarce. There are no mature bankers who have been loan officers and then vice Presidents of banks for twenty five years, no one has been an official of the department of an institution that oversees commercial bank ever since he graduated with an MBA from his state University twenty years ago, there are no assessors for real estate values and even if there are some who claim that skill there is no record of property ^{or rental} values to support the assessment.

The historical fact that of beginning with a clean slate indicates that the oversight jobs should be kept simple. For a country emerging from Soviet style Communism the competence to administer determines the regulatory structure. This comes down to setting up the financial structure with institutions that are limited in what they can do and to set up specialized regulatory and control organizations: a horses for courses institutional structure indicates that the regulatory structure should be compartmentalized with special institutions overseeing specialized financial institutions.

IV. Conclusion

The banking and financial systems of a capitalist economy are complex and their proper functioning is a major determinant of how well the economy functions. Getting money and banking, or finance, right has been a major recurring theme in American economic history. The reformed structure put in place in 1935-1937 has survived for a longer period than any prior structure in American history and to date it has succeeded in averting another bout of debt deflation, although the recent performance of the American economy ^{tells us that} ~~calls for~~ some serious changes in the structure are in order.

The complexity of financial institutions makes me doubt the wide applicability, wisdom and efficacy of using shock therapy in the transformation of the

economies that are emerging out of the former Soviet Empire. In orthodox economics the financial institutions of an economy are assumed to exist and to be essentially unobtrusive in determining the performance of the economy. In the world as I see it both for advanced and the emerging economies the details of the financial structure are important in determining what gets done and how much is done.

In the economies emerging from Soviet communism the development of financial institutions which enter deep into the operations of the economy is not a trivial step. Each set of financial institutions needs an examining and ~~oversight~~ body. Each set of institutions needs a network of trust and ^a willingness to accept endorsements and promises. Each financial institution that funds business needs the raw data for estimating cash flows in order to price assets. Such data is lacking.

An orderly but rapid transformation requires paying explicit attention to the structure of financial institutions that are required. One financial institution which is necessary is a government holding company which can put the state enterprises into a form fit for privatization. Another set of financial institutions that specializes in financing agriculture is needed. A third set is set of independent geographically distributed small business financing banks. Urban housing banks that offer households small deposit accounts and services for transferring funds.

We could go on. The aim is to generate the institutions that abet the capital development of the economy, which means the support of new and small enterprises, ~~as well as facilitating the~~

as well as institutions which provide a temporary "meeting place" between the "socialist" ownership + private ownership
a transition during which the data which enable rational estimates of future cash flows (or profits) can be estimated.

The complexity of the financial structure and the need for ^{an independent} financial data is ~~the~~

~~financial structure~~
financial decisions are to be rational compared to production ~~rather than~~ rather than the theory